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THE FIDUCIARY DUTY OF SECURITIES BROKERS AND INVESTMENT ADVISERS: SOLE INTEREST OR BEST INTEREST?

AN ANALYSIS OF THE ADMINISTRATION'S PROPOSAL

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AN ANALYSIS OF THE ADMINISTRATION'S PROPOSAL

The Administration on June 17, 2009 released a White Paper describing a number of reforms to correct deficiencies in the financial regulatory system.[1] Among these were recommendations for imposing a fiduciary duty on securities broker-dealers and clarifying the duty applicable to investment advisers.[2] On July 10, 2009, the Administration released a legislative proposal to implement its recommendation.

This memorandum analyzes the Administration's legislative proposal and provides background information concerning the respective duties of broker-dealers and investment advisers under current law.

As discussed below, this paper concludes that the Administration's legislation would impose an impractical standard of conduct on[RHS1] broker-dealers and investment advisers and potentially confuse investors. This paper suggests an alternative fiduciary standard that would be more workable while achieving the Administration's goals.

I. NEED FOR LEGISLATION

A. No Fiduciary Standard For Brokers

Broker-dealers, unlike investment advisers, generally are not treated as fiduciaries under the federal securities laws. As agents, they have fiduciary-like duties under state agency law, and their activities are subject to fiduciary-like regulation under the Securities Exchange Act of 1934 and FINRA rules

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[1] U.S. Department of the Treasury, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation (publicly released on June 17, 2009) (the "White Paper").

[2] White Paper at 71-72.

that prohibit fraud and require disclosure of conflicts of interest.[3] But historically broker-dealers have not had the status of fiduciaries and the scope of their fiduciary duty to clients is determined on a highly fact-specific, case-by-case basis.[4] In particular, the anti-fraud provisions of the Securities Exchange Act of 1934 have not operated as a code of fiduciary conduct. Accordingly, the nature and scope of a broker-dealer's duties to its customers has been a source of confusion (and sometimes controversy) in recent years.

Broker Exemption from Investment Advisers Act

Broker-dealers that offer investment advice for compensation may be required to register as investment advisers and thereby acquire fiduciary status under the Investment Advisers Act.[5] Otherwise, they generally are exempt from the Act. An "investment adviser" is defined in the Investment Advisers Act of 1940 as:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business,

[3] The history of the Securities Exchange Act of 1934 indicates that it was motivated by a desire on the part of President Roosevelt and Congress to impose fiduciary duties on securities broker-dealers and that the anti-fraud provisions of the Act were intended to accomplish this purpose. *See* John H. Walsh, A Simple Code of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry, 29 Hofstra L. Rev. 1015 (2000-2001).

[4] In general, a broker-dealer will not be found to be a fiduciary unless a court determines that it has acted in a position of trust and confidence with a customer based on the specific facts of the case. In *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc*., for example, the court ruled that a broker who had de facto control over a non-discretionary account generally owed customer duties of a fiduciary nature. The court said it was appropriate to look at the customer's sophistication and degree of trust and confidence in the relationship, among other things, to determine the duties owed by the broker. 461 F. Supp. 951 (E.D. Mich. 1978), aff'd, 647 F. 2d. 165 (6th Cir. 1981). In *Paine Webber, Jackson & Curtis, Inc. v. Adams*, the court said that the existence of a fiduciary relationship may be proven by evidence that a customer has placed trust and confidence in the broker by giving practical control of account. 718 P.2d. 508 (Colo. 1986). In *SEC v. Ridenour*, a bond dealer was found to owe a fiduciary duty to customers with whom he had established a relationship of trust and confidence. 913 F.2d. 515 (8th Cir. 1990).

[5] The fiduciary status of investment advisers is discussed *infra*.

> issues or promulgates analyses or reports
> concerning securities. . . .[6]

The Act provides an exemption for "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore."[7] In general, a broker-dealer's advice is not considered to be "solely incidental" to its brokerage business if it charges a separate fee or separately contracts for advisory services, or if it exercises investment discretion.[8]

"Merrill Lynch Rule"

The SEC in 2005 promulgated a rule exempting broker-dealers from the Advisers Act with respect to certain "special compensation" for investment advice.[9] The so-called "Merrill Lynch Rule" was designed to exempt broker-dealers that charged asset-based fees in lieu of commissions for their services, including incidental investment advice. The SEC noted that fee-based brokerage accounts, similar to traditional full service brokerage accounts, provide a package of services, including execution, incidental investment advice, and custody. In a fee-based brokerage account, the customer pays a fee based upon the amount of assets in the account (an asset-based fee) as opposed to a commission (i.e., a mark-up or mark-down) for each transaction.[10]

In order to qualify for the exemption, a broker-dealer was required to make the following disclosure to its clients with respect to fee-based accounts:

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[6] Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11). Banks and bank holding companies generally are exempt from regulation as investment advisers (except when they act as investment advisers to registered investment companies).

[7] 15 U.S.C. § 80b-2(a)(11)(C). In addition, the SEC may exempt from investment adviser regulation "such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order." 15 U.S.C. § 80b-2(a)(11)(F).

[8] *See* 72 Fed. Reg. 55126 (Sept. 28, 2007).

[9] *See* "Certain Broker-Dealers Deemed Not to be Investment Advisers," 70 Fed. Reg. 20,424 (Apr. 19, 2005). The SEC said the rule would benefit investors for the following reasons: "Under the fee-based programs . . . , a broker-dealer's compensation does not depend on the number of transactions or the size of mark-ups or mark-downs charged, thus reducing incentives for the broker-dealer to churn accounts, recommend unsuitable securities, or engage in high-pressure sales tactics. As such, these programs may better align the interests of broker-dealers and their customers. The rule would also benefit customers by enabling them to choose from among these new programs and other traditional brokerage services to select the program best for them. While it is difficult to quantify the value of these benefits, we believe they are substantial."

[10] *See* 72 Fed. Reg. 55126, 55127 n.2 (Sept. 28, 2007).

> the accounts are brokerage accounts and not advisory accounts. . . . that, as a consequence, the customer's rights and the firm's duties and obligations to the customer, including the scope of the firm's fiduciary obligations, may differ. . . .[11]

The disclosure implied that a broker-dealer had some fiduciary duties and obligations, but it was unclear what those might be. Moreover, a broker-dealer was not required to state how its fiduciary duties and obligations to the customer differed from the customer's "rights."

The Merrill Lynch Rule was struck down by the U.S. Court of Appeals for the District of Columbia Circuit in 2007.[12] The court ruled that the SEC lacked statutory authority to exempt classes of broker-dealers other than those specifically exempted by the Exchange Act. The SEC decided not to appeal the court's ruling but instead said it would consider whether further rulemaking or interpretations were necessary regarding the application of the Advisers Act to these accounts and the issues resulting from the court's decision.[13]

The SEC estimated that the court's ruling affected fee-based accounts at broker-dealers with over $300 billion in assets under management.[14] To avoid disrupting these accounts, the SEC adopted a temporary interim rule (until December 31, 2009) permitting a broker-dealer that registers as an adviser to engage in principal trades for non-discretionary advisory accounts if it complies with certain disclosure requirements.[15] The restrictions on principal trades is a major reason why many broker-dealers did not register as investment advisers in the past.

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[11] 17 C.F.R. § 275.202(a)(11)-1 (as adopted) (struck down in Financial Planning Association v. Securities and Exchange Commission, 482 F.3d 481 (D.C. Cir. 2007).

[12] Financial Planning Association v. Securities and Exchange Commission, 482 F.3d 481 (D.C. Cir. 2007).

[13] SEC Press Release 2007-95 (May 14, 2007).

[14] SEC Press Release 2007-95 (May 14, 2007).

[15] These include the requirements to: (i) provide written prospective disclosure regarding the conflicts arising from principal trades; (ii) obtain written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions; (iii) make certain disclosures either orally or in writing and obtaining the client's consent before each principal transaction; (iv) send to the client confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction; and (v) deliver to the client an annual report itemizing the principal transactions. Investment Advisers Act, Temporary Rule 206(3)-3T, 72 Fed. Reg. 55022 (Sept. 28, 2007).

The SEC said that compliance with the temporary rule would not relieve a broker-dealer from fiduciary obligations under the Advisers Act, including the duties to seek best execution of client transactions and to disclose material facts necessary to alert clients to the adviser's potential conflicts of interest.

B. No Clear Fiduciary Standard for Investment Advisers

The Securities and Exchange Commission and the courts have long interpreted the Investment Advisers Act of 1940[16] as giving investment advisers the status of fiduciaries and imposing on them fiduciary duties designed to prevent conflicts of interest:[17]

> The Investment Advisers Act of 1940 thus reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship," as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested. * * * *
>
> Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arm's-length transaction. Courts have imposed on a fiduciary an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts," as well as an affirmative obligation "to employ reasonable care to avoid misleading" his clients.[18] (emphasis added)

The nature of the fiduciary duty of an investment adviser, however, apart from the duty of disclosure, is unclear. As interpreted by the SEC, it does not amount to a "sole interest" standard but requires advisers to manage their clients' portfolios in the "best interest" [RHS2]of clients.[19] Moreover, the

[16] 15 U.S.C. § 80b ("Advisers Act").
[17] *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).
[18] SEC v. Capital Gains Bureau, 375 U.S. 180 (1963) (footnotes omitted).
[19] Release No. IA-2333; File No. S7-30-04; Registration Under the Advisers Act of Certain Hedge Fund Advisers (2005).

SEC has said that the Advisers Act does not impose a detailed regulatory regime on investment advisers and contains only few basic requirements:

> The Act contains a few basic requirements, such as registration with the Commission, maintenance of certain business records, and delivery to clients of a disclosure statement ("brochure"). Most significant is a provision of the Act that prohibits advisers from defrauding their clients, a provision that the Supreme Court has construed as imposing on advisers a fiduciary obligation to their clients. This fiduciary duty requires advisers to manage their clients' portfolios in the best interest of clients, but not in any prescribed manner. A number of obligations to clients flow from this fiduciary duty, including the duty to fully disclose any material conflicts the adviser has with its clients, to seek best execution for client transactions, and to have a reasonable basis for client recommendations. The Advisers Act does not impose a detailed regulatory regime.[20]

The fiduciary duties of investment advisers under the Advisers Act arise from the anti-fraud provisions in section 206 of the Act.[21] Under section 206, it is unlawful for any investment adviser to employ any device, scheme, or artifice to defraud any client or prospective client or to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.[22] Section 206 also makes it unlawful for

[20] *Id.*

[21] 15 U.S.C. § 80b-6. Not all advisers are required to register with the SEC under the Advisers Act. As noted, broker-dealers are exempt under certain circumstances. Banks also are exempt, except when they act as is to investment companies. The bank exemption reflects the Congressional understanding that banks are subject to fiduciary duties under state law. However, banks generally are not subject to state trust law or other fiduciary law when they provide investment advice in the absence of a trust. The Advisers Act also exempts an adviser from registration if it (i) has fewer than fifteen clients, (ii) does not hold itself out generally to the public as an investment adviser, and (iii) is not an adviser to any registered investment company. The SEC lacks authority to conduct examinations of advisers exempt from the Act's registration requirements. Investment advisers with less than $25 million in assets under management are regulated by the states rather than the SEC.

[22] In addition, section 206 makes it unlawful for an investment adviser, acting as principal for his own account, knowingly to sell any security to or purchase any security from a client

an investment adviser to engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative, and requires the SEC to adopt rules defining such acts, practices, and courses of business and prescribing means reasonably designed to prevent them.[23]

The SEC has adopted rules addressing various areas where conflicts of interest may arise in the activities of an investment adviser. The rules impose requirements relating to disclosure statements, books and records, advertising, solicitation of clients, custody of client assets, principal and agency cross trades, codes of ethics, and compliance programs.[24]

However, the source and scope of an investment adviser's fiduciary duty are ambiguous. The scope of an investment adviser's fiduciary duty never has been set forth by rule or addressed in detail by the SEC outside of enforcement actions.

An SEC official in a speech in 2006 addressed the fiduciary duty of investment advisers and said the duty derives from the common law.[25] The official did not cite to any specific common law, however, or discuss in detail the common law fiduciary duties of investment advisers.[26] More recently, an SEC Commissioner proclaimed that all investment professionals should be subject to a fiduciary duty obligating them to act in the "best interests" of their customers, but did not elaborate on the source or scope of any such standard.[27]

The fiduciary duties applicable to an investment adviser under the Investment Advisers Act of 1940 are enforceable by the SEC, but not by individual clients. There is no private right of action under the Advisers Act.

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or, acting as broker for a person other than the client, knowingly to effect any sale or purchase of any security for the account of the client, without disclosing to such client in writing before completion of the transaction the capacity in which he is acting and obtaining the consent of the client to the transaction. This prohibition does not apply to any transaction with a customer of a securities broker if the securities broker is not acting as an investment adviser in the transaction.

[23] The language of the anti-fraud provisions of section 206 of the Investment Advisers Act is included in the appendix.

[24] *See* 17 C.F.R. Pt. 275.

[25] Speech by Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations, Feb. 27, 2006.

[26] The common law is made by judges in cases arising under state law over time. It may vary from state to state. No federal fiduciary standard applies to investment advisers, other than advisers to employee benefit plans under ERISA.

[27] Speech by SEC Commissioner Elisse B. Walter, May 5, 2009.

[RHS3]Thus, unlike a beneficiary of a trust, for example, a client cannot enforce the fiduciary duty owed to him. Rather, the client must rely on the SEC to take enforcement action against the adviser, which is aimed more at creating a general deterrent effect than redressing particular client harm.

II. ADMINISTRATION PROPOSAL

The Administration's proposal is intended to address the need for greater clarity concerning the fiduciary duty owed by broker-dealers and investment advisers to their clients.

A. Administration White Paper

The Administration's White Paper notes that broker-dealers and investment advisers often provide virtually identical services but are regulated under different regulatory regimes. Because investment advisers are fiduciaries under the law whereas broker-dealers generally are not, the Paper notes that customers often are confused as to which type of entity they are dealing with and what duties are owed to them under the law.

To the extent that broker-dealers provide investment advice, the White Paper recommends that they be subject to the same duties as investment advisers. Toward this end, the White Paper recommends that the SEC be permitted to align the duties of broker-dealers with those of investment advisers and impose a fiduciary standard on broker-dealers that provide investment advice. In addition, the White Paper advocates legislation to provide simple and clear disclosures to investors regarding their relationships with investment professionals and to expressly prohibit certain conflicts of interest and sales practices that are contrary to investor interests.[RHS4][28]

B. Proposed Legislation

The specific language of the Administration's legislation is appended hereto. The language would not achieve the purposes set forth in the Administration's White Paper but rather would establish an unworkable fiduciary duty based on misapplication of state trust law principles, as discussed *infra*.[RHS5]

[28] Relevant excerpts from the White Paper are attached hereto.

"Sole Interest" Standard

The central feature of the Administration's bill is a "sole interest" standard that would require broker-dealers and investment advisers to act "solely" in the interests of their clients. The bill amends both the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to provide that the SEC:

> may promulgate rules to provide, in substance, that the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers or clients as the Commission may by rule provide), shall be to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice. (emphasis added)

The Administration's language does not use the word "fiduciary" or "fiduciary duty." Nevertheless, the clear intent of the language is to impose a fiduciary standard, and the "sole interest" standard would operate as such.

It is important to note, however, that broker-dealers who do not give investment advice would remain exempt from fiduciary status and would not be subject to the "sole interest" standard. Also, neither broker-dealers nor investment advisers would be subject to the "sole interest" standard with respect to *non-retail* customers, unless the SEC by rule extends it to other types of customers.

Sales Practice Rules

The Administration's bill also would require the SEC to "examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors."

Disclosures to Customers

The Administration's bill also would require the SEC to "take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals."

III. MISGUIDED "SOLE INTEREST" STANDARD

The "sole interest" standard in the Administration's bill is misguided. It appears to be based on a strict duty of loyalty derived from trust law.[29][RHS6] The legislation misapprehends the nature of trust law, however, and does not incorporate trust law provisions that make the duty of loyalty reasonable and practical in modern day trust applications.[30][RHS7]

As a preliminary matter, it is important to understand that trust law addresses circumstances that are much different from those which the securities laws address. Trust law in its strictest form is designed to protect beneficiaries of testamentary, charitable, and other trusts who are incapable of acting for themselves (such as widows, orphans, and yet-to-be beneficiaries) and who often do not have the option of replacing the trustee with a trustee of their choice. Trust law operates to fulfill the purposes of the trust settlor under the auspices of a trustee according to the terms of a trust. The beneficiaries generally can control neither the terms of the trust nor the trustee. Investors, on the other hand, ordinarily can control who manages their assets and how. They <u>do</u> have the option of choosing their own securities broker-dealers and investment advisers and can change from one firm to another if they believe their interests are not being served.

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[29] ERISA also includes a "sole interest" duty of loyalty under which an ERISA fiduciary must discharge its duties "solely in the interests of the participants and beneficiaries . . . for the exclusive purpose of . . . providing benefits to participants and their beneficiaries [and] defraying reasonable expanses of administering the plan." ERISA § 404(a)(1).

[30] State trust law is derived from judicial "common law" rulings and state statutes, such as state law adoptions of the Uniform Trust Code and the Uniform Prudent Investor Act. There is no federal trust law. The Uniform Trust Code refers to the "common law" pertaining to trusts as follows: "To determine the common law and principles of equity in a particular state, a court should look first to prior case law in the state and then to more general sources, such as the Restatement of Trusts. . . .The common law of trusts is not static but includes the contemporary and evolving rules of decision developed by the courts in exercise of their power to adapt the law to new situations and changing conditions. It also includes the traditional and broad equitable jurisdiction of the court, which the Code in no way restricts." Uniform Trust Code § 106.

Because of the unique role of trustees, trust law imposes strict duties on them. The duty of loyalty is the foremost duty of a trustee and is articulated in the Restatement of Trusts (Third) as follows: "Except as otherwise provided in the terms of the trust, a trustee has a duty to administer the trust solely in the interest of the beneficiaries. . . ."[31] The duty of loyalty also is reflected in the Uniform Trust Code which provides that "[a] trustee shall administer the trust solely in the interests of the beneficiaries."[32] The standard applies "except as otherwise provided in the terms of the trust."[33]

It is important to emphasize, however, that the "sole interest" standard and other duties of a trustee are default rules that apply only when the terms of the trust are silent or absent.[34] The terms of the trust instrument generally govern the trust relationship and prevail over any contrary provisions of law, with certain exceptions. A trustee always must act "in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries."[35]

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[31] Restatement of Trusts (Third) § 78, Duty of Loyalty (2007) (emphasis added). The Restatement of Trusts is an authoritative statement of the law based on prevailing court opinions and rulings. It was substantially updated and revised in 2007.

[32] Uniform Trust Code § 802 (emphasis added). The Uniform Trust Code was adopted by the National Conference of Commissioners on Uniform State Laws in 2004 and has been widely adopted by the states. The Uniform Trust Code is the first national codification of the law of trusts and is intended to provide "precise, comprehensive, and easily accessible guidance on trust law questions." On issues where state laws diverge or on which the law is unclear or unknown, the Code provides a uniform rule.

[33] Uniform Trust Code § 105(a). Both the Uniform Trust Code and the Uniform Prudent Investor Act specifically pertain only to trustees and not to other fiduciaries, although the principles in each may guide the conduct of other fiduciaries. The comments to the Uniform Trust Code specifically state: "The Uniform Trust Code, while comprehensive, applies only to express trusts." Uniform Trust Code § 102, Comment. *See also* Restatement of Trusts (Third) § 1 and Introductory Note: "The term "trust" is sometimes used to encompass all fiduciary relationships. This Restatement does not use the term in this broad sense, given that so many of the rules applicable to trustees are not applicable to other fiduciaries. Thus, an executor, guardian, agent, or corporate officer or director is a fiduciary, but the fiduciary duties and relationships involved differ in many ways from those of a trustee."

[34] The comments to the Uniform Trust Code state: "the Uniform Trust Code is primarily a default statute. While this Code provides numerous procedural rules on which a settlor may wish to rely, the settlor is generally free to override these rules and to prescribe the conditions under which the trust is to be administered. With only limited exceptions, the duties and powers of a trustee, relations among trustees, and the rights and interests of a beneficiary are as specified in the terms of the trust." Comment to § 105(a). *See also* Restatement of Trusts (Third) § 4, Comment a(1).

[35] Uniform Trust Code § 105(b).

Both the Restatement and Uniform Trust Code allow conflict of interest transactions when specifically authorized by law or court order, by the trust instrument, or with consent of the beneficiaries. For example, the Uniform Trust Code provides that a transaction involving the investment of trust property which is affected by a conflict of interest is not voidable by the trust beneficiary if the transaction was authorized by the terms of the trust or the beneficiary consented to the trustee's conduct or ratified the transaction.[36] [RHS8]

A trust settlor may modify the sole interest standard in the trust agreement to address appropriate matters. For example, the terms of the trust may permit the trustee to invest trust assets in investments from which the trustee derives some benefit, such as deposits in the trustee bank or mutual funds for which the trustee acts as investment adviser. The trust instrument may authorize the trustee to purchase securities or other assets from the trustee or engage in other transactions in which the trustee has an interest, provided the trustee discloses its conflicts of interest.

The Uniform Trust Code specifically provides that the duty of loyalty does not preclude the following transactions provided they are "fair to the beneficiaries":

- an agreement between a trustee and a beneficiary relating to the appointment or compensation of the trustee;
- payment of reasonable compensation to the trustee;
- a transaction between a trust and another trust, decedent's estate, or conservatorship of which the trustee is a fiduciary or in which a beneficiary has an interest;
- a deposit of trust money in a regulated financial-service institution operated by the trustee; or
- an advance by the trustee of money for the protection of the trust.[37]

The Uniform Trust Code specifically authorizes a trustee to incur costs in administering a trust account, provided the costs are reasonable: "In administering a trust, the trustee may incur only costs that are reasonable in relation to the trust property, the purposes of the trust, and the skills of the

[36] *Id.*
[37] Uniform Trust Code § 802(h).

trustee."[38] The Code also specifically states that it is not a conflict of interest for a trustee to invest trust assets in a proprietary mutual fund provided the trustee conforms with the prudent investor rule as articulated in the Code.[39]

None of these exceptions is reflected in the Administration's bill. Without such exceptions, the Administration's bill creates a fiduciary standard that is stricter than trust law. [RHS9] The Administration bill will not work in the context of a securities brokerage or investment advisory relationship where brokers and advisers commonly engage in transactions involving known conflicts of interest. To the extent that conflicts of interest are not adequately disclosed, the law can be changed to impose more rigorous disclosure requirements.

The Administration's bill would impose the "sole interest" trust law standard without allowing for reasonable modifications in the terms of the account agreement to address conflicts of interest. The bill thus ignores the provisions of trust law that make it flexible and workable. Under the strict language in the Administration's bill, as noted, a broker-dealer or investment adviser could not receive any compensation for its services because it would be acting in its own interest in doing so.

It is noteworthy that some trust law experts recently have questioned the continued need for the "sole interest" standard in the trust law and have advocated a "best interest" standard instead.[RHS10][40] Under the best interest standard, a trustee could undertake transactions in which it has a conflict of interest provided it can show that the transaction was prudently undertaken in the best interest of the beneficiary.[41]

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[38] Uniform Trust Code § 805. The comment to the Uniform Trust Code states that the "duty not to incur unreasonable costs" applies not only to the trustee's administration of the trust but when a trustee decides whether and how to delegate to agents: "In deciding whether and how to delegate, the trustee must be alert to balancing projected benefits against the likely costs. To protect the beneficiary against excessive costs, the trustee should also be alert to adjusting compensation for functions which the trustee has delegated to others." Uniform Trust Code § 805, Comment.

[39] Uniform Trust Code § 802(f).

[40] *See* John H. Langbein, Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?, 114 Yale L.J. 929 (2005). Professor Langbein served on the drafting committee for the Uniform Trust Code and was the reporter for the Uniform Prudent Investor Act.

[41] *Id.*

IV. ALTERNATIVE "BEST INTEREST" STANDARD

In order to be workable, any fiduciary duty imposed on an investment advisory or securities brokerage firm must have flexibility to allow transactions where the firm has a mutual interest with that of the client, provided the firm's interest is not permitted to take precedence over the client's interest. [RHS11]

If a sole interest standard is adopted, provision could be made to allow exceptions for such transactions in the client agreement. But then the standard would become meaningless because client contracts would be so riddled with exceptions that no circumstances would exist in which a firm would acting "solely" in the client's interest.[42] Some residual, irreducible standard is needed that cannot be contracted away.[RHS12]

Under the sole interest standard in trust law, the trustee is under an immutable duty to always act "in good faith" and in accordance with the interests of the beneficiaries, notwithstanding exceptions in the trust agreement. That residual standard is similar to the good faith and fair dealing obligations that currently apply to investment advisers and broker-dealers under the securities laws.[43] The existing securities law standards, however, are vague and do not afford a sufficiently high level of investor protection to meet the goals of the Administration and others who have criticized the existing regime.

To answer the need for greater client protection, a more workable and effective fiduciary standard is needed. One alternative might be a "best interest" standard whereby an investment fir[RHS13]m is required to act in the

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[42] Indeed, Professor Langbein has noted that the "sole interest" standard in trust law has become "increasingly fictional" as a baseline norm in trust law because of all of the exclusions and categorical exemptions that have been made, mostly to serve the interests of beneficiaries. *See* John H. Langbein, Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?, 114 Yale L.J. 929, 980 (2005) ("Across vast swaths of trust practice. . . the sole interest rule no longer accurately describes our law and practice.")

[43] Under FINRA rules, for example, broker-dealers are subject to a duty of fair dealing: "Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's Rules, with particular emphasis on the requirement to deal fairly with the public." FINRA/NASD Rule 2310, IM-2310-2.

client's best interest rather than sole or exclusive interest.[44] The best interest standard would allow transactions where the interests of the firm and the client are mutually aligned, provided the client's interests always take precedence. Conflicts of interest would be allowed, but the firm would never be permitted to put its interests ahead of the client's. [RHS14]

Under a best interest standard, for example, the suitability rule that currently requires brokers to give suitable investment recommendations might be revised as follows:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is ~~suitable~~ ~~for~~ in the best interests of such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.[45]

A broker might breach the best interest standard, for example, if it recommended that its clients invest in an affiliated mutual fund whose performance and expense ratios are materially unfavorable when compared to similar unaffiliated funds, even though the broker's affiliation with the fund's adviser is disclosed. Similarly, a broker that advised its clients to place their assets in deposits of an affiliated bank would breach the best interest standard if the broker knew that the bank was in danger of failing or under close supervisory scrutiny.

Full and accurate disclosure of potential conflicts is an obvious component of a best interest standard, as of any fiduciary standard. In addition, to ensure that the standard is meaningful, a requirement for client consent should be a prerequisite for certain transactions, such as when a broker acts in a principal capacity. Regulations will be needed to define when

[44] Professor Langbein has advocated a "best interest" standard in trust law in lieu of the "sole interest" standard. *See* John H. Langbein, Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?, 114 Yale L.J. 929 (2005). SEC officials also have advocated a best interest standard for broker-dealers and investment advisers, as noted elsewhee. A best interest standard also would be consistent with SEC decisions under the Investment Advisers Act.

[45] *See* FINRA/NASD Rule 2310(a). *See also* prudent investor standard discussed *infra*.

customer consent is necessary in a conflict situation, as opposed to mere disclosure.

A "best interest" standard would be similar to the standard reflected in the duty of loyalty imposed on agents under state agency law. [RHS15] The Restatement (Third) of Agency recognizes a specific duty of loyalty by an agent to his principal:

> An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship.[46]

In contrast to the duty of loyalty applicable to trustees, an agent's duty of loyalty does not require the agent to act "solely" in the interests of beneficiaries. The agent may engage in transactions that benefit the agent as well as the principal, provided that the agent's interests are not placed ahead of those of the principal:

> Although an agent's interests are often concurrent with those of the principal, the general fiduciary principle requires that the agent subordinate the agent's interests to those of the principal and place the principal's interests first as to matters connected with the agency relationship.[47]

A principal may be compensated so that the agent's interests are concurrent with those of the principal.[48] Nevertheless, an agent is not free to abuse the agency relationship. The duty of loyalty includes several specific related duties. For example, an agent may not acquire a material benefit from a third party in connection with transactions undertaken on behalf of the principal.[49] Similarly, an agent may not deal with the principal as an adverse party, or on behalf of an adverse party, in a transaction connected with the agency relationship.[50] An agent also may not use property of the principal for the agent's own purposes or those of a third party.[51]

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[46] Restatement (Third) of Agency § 8.01.
[47] Restatement (Third) of Agency § 8.01 comment b.
[48] Restatement (Third) of Agency § 8.01 comment b.
[49] Restatement (Third) of Agency § 8.02.
[50] Restatement (Third) of Agency § 8.03.
[51] Restatement (Third) of Agency § 8.05.

Under the Restatement, conduct by an agent that would otherwise constitute a breach of the agent's duty is deemed not to be a breach if the principal consents to the conduct, provided that, in obtaining the principal's consent, the agent acts in good faith, discloses all material facts that the agent knows or should know would reasonably affect the principal's judgment, and otherwise deals fairly with the principal.[52] In addition, the transaction involved must be of a type that "could reasonably be expected to occur in the ordinary course of the agency relationship."[53]

To be effective, a best interest standard would need to be clearly articulated, along with the specific associated duties, such as the duty of prudence in investing client assets, as discussed below. A best interest standard generally could be reflected in the terms of the investment agreement, as in the following disclosure example:

> We pledge and agree to act in your best interests with respect to any investment advice or recommendations we may give to you and any transactions we may engage in on your behalf.
>
> We are required by law to disclose to you any commissions or other financial interest that we may have in any transactions that we recommend to you or engage in on your behalf, and we will make such disclosures to you in accordance with the law in the Disclosure Document attached hereto and otherwise in accordance with the law.
>
> We are required by law to obtain your specific consent before we engage in certain transactions on your behalf, and we will not engage in such transactions without your consent.
>
> The Disclosure Document attached hereto discloses the specific types of transactions that we may recommend to you or engage in on your behalf where we receive commissions or have a financial interest.

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[52] Restatement (Third) of Agency § 8.06.
[53] *Id.*

> The Disclosure Document allows you to consent to certain of such transactions where your consent is required by law in advance. In addition, we may be required by law to request your consent at the time of the transaction.
>
> In addition, it is your right to require that we obtain your specific consent before we engage in any transaction in which we have a financial interest, and you may indicate your preference in this regard on the form provided in the attached Disclosure Document.

SEC rules would need to specify transactions that may be engaged in by a broker only with the client's consent, along with the method of consent required.

V. PRUDENT INVESTOR STANDARD

A prudent investor standard of care is an important corollary to either a "sole interest" or "best interest" standard of conduct when a broker exercises discretionary investment authority. [RHS16]

The Uniform Prudent Investor Act sets forth the prudent investor standard in trust law as follows:

> A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.[54]

This duty also is articulated in the Uniform Trust Code as follows:

> A trustee shall administer the trust as a prudent person would, by considering the purposes, terms, distributional requirements, and other circumstances

[54] Uniform Prudent Investor Act § 2(a). *See* appendix hereto for the complete language.

> of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.[55]

Like the duty of loyalty, the duty of prudent investing may be modified by the terms of a trust:

> The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.[56]

A host of subsidiary duties also applies under the Uniform Prudent Investor Act, such as the duty to incur only reasonable expenses on behalf of a trust, to receive only reasonable compensation, to disclose material information, and to maintain the confidentiality of private information.[57] The Administration's bill is silent on these fiduciary duties and should be expanded to encompass them.

The duty of prudent investing particularly seems relevant to a broker-dealer or investment adviser that exercises investment discretion in managing client assets. The standard of care applicable to agents under the Restatement of Agency does not appear adequate for this purpose. The Restatement imposes a duty of "care, competence, and diligence" on an agent as follows:

> Subject to any agreement with the principal, an agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances.[58]

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[55] Uniform Trust Code § 804.

[56] Uniform Prudent Investor Act § 1(b).

[57] *See, e.g.*, Uniform Prudent Investor Act § 7 ("In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.").

[58] Restatement (Third) of Agency § 8.08. Special skills or knowledge possessed by an agent are taken into account in determining whether the agent acted with due care and diligence. If an agent professes to have special skills or expertise, the agent has a duty to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge. Restatement (Third) of Agency § 8.08.

The Restatement of Agency does not specifically impose any “prudent investor” standard on agents with respect to investments, although it is possible an agent could be held to the prudent investor standard as a matter of industry practice.

VI. OTHER PROBLEMS WITH ADMINISTRATION BILL

Apart from a flawed [RHS17]fiduciary standard, the Administration’s bill has other problems also.

A. Existing Standards Would Be Swept Aside

The Administration’s bill could have the effect of transforming existing standards of conduct for broker-dealers and investment advisers into an overriding “sole interest” fiduciary standard.

The legislative language contradicts and would negate existing standards that allow broker-dealers and investment advisers to engage in transactions that benefit their clients where their own interests also are served. The “sole interest” standard would preclude transactions where the broker-dealer or investment adviser has any interest in the transaction whatsoever, even when fully disclosed to the client. Such transactions could include, for example, situations where:

- an adviser has an interest in the investment being recommended (e.g., selling commissions or 12b-1 fees);
- an adviser owns or is affiliated with a broker through which clients’ transactions will be traded;
- an adviser or related party compensates a third party for referring a client.[59]

Under existing law, these transactions are permitted provided that appropriate disclosure is made to the client. These transactions would *not* be permissible under a “sole interest” standard. The sole interest standard, without more, would preclude a broker-dealer or investment adviser from receiving *any* compensation for its services and thus would make it impossible for much of the brokerage industry to even exist.

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[59] *Id.*

The status of numerous FINRA broker conduct rules would be in doubt as a result of the legislation, including various disclosure requirements.

B. Anti-Fraud Provisions Potentially Conflict

The imposition of a "sole interest" standard on broker-dealers and investment advisers would be in addition to the statutory anti-fraud provisions that already apply to broker-dealers and investment advisers under the Securities Exchange Act and the Investment Advisers Act. Conduct that violates the anti-fraud provisions most likely would also violate the "sole interest" standard. But the two standards are not co-extensive.

It is possible that conduct in violation of the sole interest standard might not necessarily be fraudulent. For example, scienter is not a requirement to find a violation of the sole interest standard in trust law, whereas it generally is a requirement for a violation of the anti-fraud provisions. Similarly, harm to the investor generally is a requirement for a finding of fraud, whereas a violation of the sole interest standard may occur without actual harm. The customer's knowing consent to a transaction would be a defense against fraud, but not against a claim that a broker failed to act in the customer's sole interest.

The co-existence of a strict fiduciary standard along with the anti-fraud provisions creates the possibility of conflicting interpretations and confusion in the law and could complicate enforcement actions and other investor protection initiatives.

C. Fiduciary Rulemaking is Not Mandatory

The Administration's bill does not require the SEC to promulgate rules but rather states that it "may" do so. Accordingly, although it seems unlikely, the SEC could elect not to adopt regulations imposing a "sole interest" fiduciary duty on either broker-dealers or investment advisers under the legislation. But the SEC's authority to adopt some other standard may be doubtful.

D. SEC Regulatory Authority Is Questionable

The Administration's bill raises a question as to whether the SEC could promulgate a fiduciary standard for broker-dealers and investment advisers other than the "sole interest" standard. The legislation as proposed could limit the SEC's authority to do so.

An inference might be drawn from the legislation that Congress believes that the SEC currently does not have authority to impose a "sole interest" fiduciary standard on either broker-dealers or investment advisers. The inference raises a question as to what authority the SEC does have currently to impose or regulate a fiduciary standard of any kind.

E. Sales Practice Rules May Conflict with Fiduciary Duty

As noted, the legislation authorizes the SEC to "examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors."

This language appears to contemplate standards of conduct different from and potentially inconsistent with the "sole interest" standard. The standard is based on what is contrary to the "public interest" and the "interests of investors." The language does not authorize the SEC to prohibit sales practices that are not in the "sole interest" of the client, although the language establishing the "sole interest" standard suggests that it should have such authority.

Moreover, the language does not authorize the SEC to *regulate* sales practices or conflicts of interest, but only to *prohibit* those it deems contrary to the interests of the public and investors. The language thus could be interpreted as limiting the SEC to either permitting or prohibiting—but not regulating—a given practice. The SEC presumably could find that certain sales practices affected by a conflict of interest are not contrary to investor interests if the conflict is disclosed or if other conditions are met. But then such a practice would not be in the "sole interest" of the client.

Further, it is unclear whether this new authority to regulate sales practices would replace or supersede existing business conduct rules of the SEC and FINRA.

F. Clarity for Disclosures Is Lacking

As noted earlier, the Administration's bill would require the SEC to "take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals."

In order to do so, the SEC would need to define clearly the obligations of investment professionals to their clients. The bill does not provide sufficient authority or clarity for that purpose but rather adds complexity and the potential for further confusion.

Any required disclosures should take into account the terms of the agreement with the customer, at least to the extent the sole interest standard is modified to allow flexibility in the customer agreement.

VII. ALTERNATIVE LANGUAGE

The following language may address some of the problems noted above while achieving the Administration's basic goals:

> Investment advisers and broker-dealers that act in a position of trust and confidence with respect to their customers shall be deemed to be "fiduciaries" for purposes of this Act and shall comply with fiduciary standards of conduct prescribed by the Commission pursuant to this Act.
>
> The Commission shall promulgate regulations defining when a broker-dealer acts in a position of trust and confidence such that it is a "fiduciary" for purposes of this Act.
>
> The Commission shall promulgate regulations prescribing fiduciary standards of conduct for investment advisers and such broker-dealers that are deemed to be fiduciaries under this Act. Such fiduciary standards shall reflect principles embodied in the duty of loyalty, the duty of prudent investing, and other related duties applicable to trustees under trust and fiduciary law, as interpreted by the Commission to be relevant for the protection of investors.
>
> Any such regulation or interpretation by the Commission shall not affect the application of trust and fiduciary law to any person or trust. "Trust and fiduciary law" means the law of any state governing

> trust or fiduciary relationships, including state statutory, corporate, and common law.
>
> The Commission shall promulgate regulations requiring investment advisers and broker-dealers to disclose to their customers, in simple language, whether they are acting as fiduciaries for purposes of this Act and the scope of their fiduciary duties and obligations. The Commission shall prescribe disclosure forms for this purpose.
>
> The Commission may promulgate regulations governing sales practices, conflicts of interest, compensation, and other matters to the extent it deems necessary to guide broker-dealers and investment advisers in acting in accordance with the fiduciary standards established under this Act.
>
> The Commission's rulemaking and enforcement authority under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 shall include authority to interpret and enforce the fiduciary duties established by the Commission hereunder and otherwise shall not be affected by this Act.
>
> The Commission shall promulgate regulations to establish a means by which investors may enforce the fiduciary duty owed them under this Act and obtain redress from a broker-dealer or investment adviser for any violations thereof.

This language would require the SEC to conduct a public rulemaking and deliberate as to the appropriate fiduciary standard that should govern broker-dealers and investment advisers. Among the standards that should be considered is a "best interest" standard requiring investment firms to act in the best interest of their clients, as discussed above.

VIII. CONCLUSION

The Administration's proposal would impose an impractical "sole interest" fiduciary standard on broker-dealers and investment advisers in order

to enhance investor protection. This paper supports the concept of a "best interest" fiduciary standard as a more workable alternative and also suggests that broker-dealers and investment advisers who exercise investment discretion be subjected to a prudent investor standard.

IX. Appendices

A. Excerpt from Administration White Paper

The following is an excerpt from the Administration's White Paper:

The SEC should be given new tools to promote fair treatment of investors. We propose the following initiatives to empower the SEC to increase fairness for investors:

Establish a fiduciary duty for broker-dealers offering investment advice and harmonize the regulation of investment advisers and broker-dealers.

Retail investors face a large array of investment products and often turn to financial intermediaries – whether investment advisors or brokers-dealers – to help them manage their investments. However, investment advisers and broker-dealers are regulated under different statutory and regulatory frameworks, even though the services they provide often are virtually identical from a retail investor's perspective.

Retail investors are often confused about the differences between investment advisers and broker-dealers. Meanwhile, the distinction is no longer meaningful between a disinterested investment advisor and a broker who acts as an agent for an investor; the current laws and regulations are based on antiquated distinctions between the two types of financial professionals that date back to the early 20th century. Brokers are allowed to give "incidental advice" in the course of their business, and yet retail investors rely on a trusted relationship that is often not matched by the legal responsibility of the securities broker. In general, a broker-dealer's relationship with a customer is not legally a fiduciary relationship, while an investment adviser is legally its customer's fiduciary.

From the vantage point of the retail customer, however, an investment adviser and a broker-dealer providing "incidental advice" appear in all respects identical. In the retail context, the legal distinction between the two is no longer meaningful. Retail customers repose the same degree of trust in their brokers as they do in investment advisers, but the legal responsibilities of the intermediaries may not be the same.

The SEC should be permitted to align duties for intermediaries across financial products. Standards of care for all broker-dealers when providing investment advice about securities to retail investors should be raised to the fiduciary standard to align the legal framework with investment advisers. In addition, the SEC should be empowered to examine and ban forms of compensation that encourage intermediaries to put

investors into products that are profitable to the intermediary, but are not in the investors' best interest.

New legislation should bolster investor protections and bring important consistency to the regulation of these two types of financial professionals by:

- requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers;
- providing simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals; and
- prohibiting certain conflict of interests and sales practices that are contrary to the interests of investors.

B. Language of Administration Bill

The language in the Administration's proposal concerning the fiduciary duty of securities broker-dealers and investment advisers is as follows:

> (a) <u>AMENDMENT TO SECURITIES EXCHANGE ACT OF 1934</u>.—Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) is amended by adding at the end the following new subsections:
>
> "(k) STANDARDS OF CONDUCT.—Notwithstanding any other provision of this Act or the Investment Advisers Act of 1940, the Commission may promulgate rules to provide, in substance, that the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers or clients as the Commission may by rule provide), shall be to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice.
>
> "(l) OTHER MATTERS.—The Commission shall—
>
> "(1) take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals; and
>
> "(2) examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it

> deems contrary to the public interest and the interests of investors.”.
>
> (b) AMENDMENT TO INVESTMENT ADVISERS ACT OF 1940.—Section 211 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-11) is amended by adding at the end the following new subsections:
>
> “(f) STANDARDS OF CONDUCT.—Notwithstanding any other provision of this Act or the Securities Exchange Act of 1934, the Securities and Exchange Commission may promulgate rules to provide, in substance, that the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers or clients as the Commission may by rule provide), shall be to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.
>
> “(g) OTHER MATTERS.—The Commission shall—
>
> “(1) take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals, including consultation with other financial regulators on best practices for consumer disclosures, as appropriate; and
>
> “(2) examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors.”.

C. Anti-Fraud Provisions of Investment Advisers Act of 1940

The finding by the SEC and the courts that investment advisers are “fiduciaries” is based on the anti-fraud provisions of section 206 the Investment Advisers Act of 1940 which provides as follows:

> It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> (3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction.
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.[60]

[60] 15 U.S.C. § 80b-6.

D. Speech by SEC Commissioner Walter

The following are excerpts from a speech by SEC Commissioner Elisse B. Walter on May 5, 2009, espousing a sole interest standard:

(emphasis added)

*** * * * Uniform Standard of Conduct.** Finally, I believe that every financial professional should be subject to a uniform standard of conduct. In my view, that standard should require all financial professionals to act as fiduciaries at all times.

My statement that all financial professionals should be subject to a fiduciary duty needs some elaboration. As you probably know, the standard of conduct issue has been discussed a great deal lately. Some have characterized the different standards applicable today in a very simple way: Investment advisers are subject to a fiduciary duty, and broker-dealers are not—end of story. I find that explanation unsatisfactory. As Einstein once said, "Everything should be made as simple as possible, but not simpler." However, I do not want to dwell on current standards because I am here to talk about the future. And, in the future, a fiduciary standard should apply uniformly to all financial professionals.

Now, before I explain, I suspect that some may be thinking, here is where she is going to start watering down what the fiduciary standard really requires, perhaps to make it more palatable to broker-dealers. I assure you nothing could be further from the truth. In fact, in some respects I think that we actually need to strengthen the current standard, not dilute it. If I recommend anything that will compromise the protection that investors receive, I surely hope that you will let me know, loudly and clearly.

So let me tell you what I currently believe. First, saying that someone is a fiduciary who is required to act in the **best interests** of investors is the beginning of the analysis, not the end. As Lori Richards, the Director of the SEC's Office of Compliance, Inspections and Examinations, has noted, "This is a simple statement to make, but one that is more difficult to apply." To appreciate fully what a fiduciary standard means, and what it really means to act in the **best interest** of an investor, it is absolutely necessary to drill down and determine what duties and obligations flow from a fiduciary standard. This is why I believe that it is important that the Commission explain what a fiduciary standard requires. Both investors and the industry deserve the clarity that formal Commission guidance would provide.

Second, I believe that a fiduciary standard is not a substitute for business practice rules. Rather, the two are complementary. For one thing, business practice rules can help to flesh out the parameters of the fiduciary duty. They can also buttress the disclosure obligations of financial professionals with respect to conflicts of interest. For instance, where appropriate, the Commission can use business practice rules to

prohibit certain conflicted behavior or to require mitigation or management of the conflict. This is important when you consider that investors often do not read disclosure, and too often fail to fully understand its significance when they do.

Third, what a fiduciary duty requires depends on the scope of the engagement. Thus, it will mean one thing for a mere order taker, another thing for someone who provides a one-time financial plan, and yet something else for someone who exercises ongoing investment discretion over an account. What a fiduciary duty requires may also depend, in certain respects, on the sophistication of the investor. What may be appropriate behavior toward large institutional investors, with knowledgeable counsel, may not be appropriate behavior toward retail investors like Aunt Millie who are not always going to understand the meaning of disclosures regarding certain conflicts of interest.

Most important, whatever gloss and guidance the Commission provides, it should not deviate from the basic principle that financial professionals should always act in the best interests of investors, both large and small.

That, in sum, is my high-level approach to legislation harmonizing the regulation of financial professionals. I believe that there are numerous advantages to harmonizing legislation. First and foremost, it would provide a clear Congressional statement that all financial professionals should be held to the same, high standard of conduct. It would also address investor confusion by providing a unified system of regulation for all financial professionals offering comparable securities products and services. The Commission would no longer be responsible for overseeing duplicative sets of rules and regulations. Finally, it would preempt, hopefully once and for all, the stale arguments over the merits and demerits of the current state of the law.

E. Speech by SEC Official

The following is a speech concerning the fiduciary duty of investment advisers by an SEC official in 2006:

Fiduciary Duty: Return to First Principles

By Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission

Eighth Annual Investment Adviser Compliance Summit
Washington, D.C.
February 27, 2006

Available at: *http://www.sec.gov/news/speech/spch022706lar.htm*

Emphasis added in places

As a matter of policy, the SEC disclaims responsibility for any private statement by an employee. The views expressed here today are my own and do not necessarily reflect those of the Commission, the Commissioners or other members of the staff.

Good morning. I am pleased to be here, as you consider practical methods to address the range of compliance issues that you face. Nothing could be more important to us at SEC than helping to ensure that advisers prevent, detect and correct compliance problems. I want to thank David Tittsworth and Hugh Kennedy for inviting me to speak with you today.

As we look at the compliance environment today, there are some facts worth noting. First, there are a significant number of newly-registered investment advisers. In fact, there are approximately 10,000 advisers registered with the SEC. About 2,000 of these firms, or 20% of the total, have just registered in the last year. These firms vary — they may be recently formed, have simply grown to exceed the 25$ million assets under management threshold, or have been operational for some time, but are registering with the SEC now because of the Commission's new rules requiring the registration of hedge fund advisers. As new registrants, these firms may be new to the Investment Advisers Act of 1940.

A second fact worth noting is that all advisory firms, whatever their size, type or history in the business, owe their advisory clients a fiduciary duty. Many firms are acutely aware of their fiduciary obligation and ensure that it informs, educates and

guides their dealings and decisions. But, one only has to look at our enforcement actions and deficiencies found in exams to draw the conclusion that the application of fiduciary duty is not as embedded in many firms' cultures as it could be. In fact, I'm far from certain that all advisory firms understand their fiduciary obligations, and how they apply in the context of their own operations. Some advisers have seemed to be aware of the fiduciary duty in kind of an ethereal way — "I know it's out there but I don't really know what it is." Others have looked at fiduciary duty as strictly a compliance or legal function — not fully appreciating its significance to *all* employees of the firm. Either view is dangerous.

Fiduciary Duty

Understanding "fiduciary duty" is critical, because it is at the core of being a good investment adviser. In a very practical sense, if an adviser and the adviser's employees understand the meaning of fiduciary duty and incorporate this understanding into daily business operations and decision-making, clients should be well served, and the firm should avoid violations and scandal. Indeed, I believe that, even if advisory staff are not aware of specific legal requirements, if their decisions large and small and everyday are motivated and informed by ***doing what's right by the client***, in all likelihood, the decision will be right under the securities laws.

This is why, as an examiner, I care about advisers' fiduciary duties. I think that knowledge and familiarity with one's fiduciary duty can help firms *avoid* compliance violations. And, avoidance of violations is in everyone's best interests — yours, your clients and our markets. As examiners, we prefer to find highly compliant firms with strong compliance controls that prevent violations. To demonstrate this point, I wanted to share with you some of the most common deficiencies that we find in our examinations of investment advisers, each of which have fiduciary implications.

But first, I'd like to **look more closely at the concept of fiduciary duty**. Many different types of professions owe a fiduciary duty to someone — for example, lawyers to their clients, trustees to beneficiaries, and corporate officers to shareholders. Fiduciary duty is the first principle of the investment adviser — because the duty comes not from the SEC or another regulator, but from common law. Some people think "fiduciary" is a vague word that's hard to define, but it's really not difficult to define or to understand. Fiduciary comes from the Latin word for "trust." **A fiduciary must act for the benefit of the person to whom he owes fiduciary duties, to the exclusion of any contrary interest.**[1]

Now, some might wonder why the concept of fiduciary duty came to be applied to advisers. The Investment Advisers Act does not call an adviser a fiduciary. In fact, that word does not appear in the Act. But, the Supreme Court recognized congressional intent and held that the Advisers Act: *"reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which*

might incline an investment adviser - consciously or unconsciously - to render advice which was not disinterested."[2] And, the Court said that: **investment advisers are fiduciaries with *"an affirmative duty of 'utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' … clients."***[3]

I would suggest that an adviser, as that trustworthy fiduciary, has five major responsibilities when it comes to clients. They are:

- to put clients' interests first;
- to act with utmost good faith;
- to provide full and fair disclosure of all material facts;
- not to mislead clients; and
- to expose all conflicts of interest to clients.

These responsibilities overlap in many ways. If an adviser is putting clients' interests first, then the adviser will not mislead clients. And, if the adviser is not misleading clients, then it is providing full and fair disclosure, including disclosure of any conflicts of interest.

How do the responsibilities of a fiduciary translate into an adviser's obligations to clients each and every day? This is a key question. Probably no statute or set of rules could contemplate the variety of factual situations and decisions that an advisory firm faces. Can you imagine the number of rules and releases and regulations that this would require? Instead, the Advisers Act incorporates an adviser's fiduciary duty under Section 206, and envisions that, in whatever factual scenario, the adviser will act in the best interests of his clients.

This is a simple statement to make, but one that is more difficult to apply. In thinking about compliance with your fiduciary obligation as an adviser, start by thinking about the areas where there is a conflict of interest — between one's own interests, the interests of the firm, and/or the interests of advisory clients. These are the areas in which compliance with fiduciary obligations are likely to be most challenging. The Compliance Rule envisions this analysis, and the Commission suggested in the release adopting the rule that advisers conduct a risk assessment to identify areas of conflicts of interest.[4]

This is not a one-time effort — the nature of an adviser's relationship with its clients is full of conflicts, and those conflicts change when an adviser's business changes. Addressing and disclosing conflicts of interest is an ongoing process. While some conflicts of interest stand out, others can be very subtle, so an adviser must look, with more than a casual glance, at every aspect of its business, and its relationship with clients, and carefully consider whether it has a conflict of interest. Importantly, at this

stage, the question is not whether the adviser acts appropriately in the conflicted situation, but merely whether the conflict itself exists.

The next step, of course, is to disclose material conflicts of interest in a "full and fair" manner and to ensure your clients understand any material conflicts of interest before taking action. Because you are a fiduciary, you should not allow your client to enter the advisory relationship without a clear understanding of all material conflicts.

As I said, and in keeping with the theme of this conference — to provide practical and not just theoretical information on compliance issues — I wanted today to describe the top 5 deficiencies that we find in our exams. It's my hope also that this information may be helpful to newly-registered advisers who are seeking to better understand common compliance pitfalls, conflicts of interest and fiduciary duties. Last year, we examined over 1,500 investment advisers. In those exams, the most common deficiencies were the following:

- **Deficient disclosure** — I'll spend more time talking about disclosure in a minute.

- **Deficiencies in portfolio management** — Problems in this area included inadequate controls to ensure that investments for clients are consistent with their mandates, risk tolerance and goals, and to ensure that required records are kept. Fiduciary duty is implicated in this area because advisers have a duty to ensure that they are managing their clients' money in a manner that is consistent with the clients' direction.

- **Deficiencies with respect to advisory employees' personal trading** — Problems in this area included a lack of controls, a lack of required codes of ethics, and failure to implement stated procedures to monitor employees' personal trades to prevent employees from placing their own interests above those of their clients, by for example, front-running clients' trades, trading on non-public information, taking investment opportunities for themselves over clients — to ensure that the fiduciary is acting with the loyalty and "utmost good faith" envisioned by the Supreme Court.

- **Deficiencies in performance calculations** — Problems in this area included overstated performance results, comparing results to inappropriate indices, failing to disclose material information about how the performance results were calculated, using prohibited testimonials, and advertising past results in a misleading manner. In this area, a fiduciary must calculate and set forth its past performance in an honest way, and must provide information that is not misleading.

- **Deficiencies in brokerage arrangements and execution** — Deficiencies in this area included poor or no controls to ensure that the adviser obtains "best execution," and secretly using clients' money to pay for client referrals, and for other goods and services that benefit the adviser. Simply stated, because brokerage money belongs to the client and not to the adviser, the adviser has a fiduciary duty to ensure that it is used appropriately and that the client is aware of how his/her money will be and is being spent by the adviser.

Inadequate Disclosure

Inadequate disclosure has been on the "top 5" list of most frequent deficiencies for some time. And, as it is the most frequently-found deficiency, it's an area that clearly deserves more attention by advisory firms. As such, I'd like to spend some time this morning talking about disclosure and the adviser's fiduciary duty.

Approximately half of the deficiencies that we find in this area relate to inaccurate, incomplete, and even misleading information in Forms ADV, and half include problematic disclosure of business practices and fees charged to clients. Whether you use Form ADV or other disclosure techniques, you should take care to ensure that you are in fact providing full, accurate and complete disclosure, and written in a comprehensible language, designed to be understood by your clients.

So what should you *not* do? Let me illustrate with a few examples from recent examinations.

- Clients were not informed of the real method used to calculate the adviser's fee. Fees appeared to be lower than they were in fact.

- An adviser failed to disclose that he recommends securities to clients in which he has a proprietary interest.

- An adviser failed to disclose the risks to clients that existed by having their assets invested in private investments.

- An adviser failed to disclose that clients with directed brokerage arrangements may not achieve best execution.

- An adviser does not accurately describe the types of products and services it obtains with clients' soft dollars.

- Clients whose assets were invested in mutual funds were not told that they pay both a direct management fee to their adviser and an indirect management fee to the adviser of their mutual funds.

- An adviser stated that it did not have custody of client assets when in fact it did.
- An adviser did not disclose that it receives economic benefit from a non-client in connection with giving advice to clients.
- An adviser did not disclose that even if clients direct that their securities transactions be executed through a certain broker-dealer, the adviser did not actually execute most transactions through that firm.
- An adviser had not amended its ADV for several years although the rules require that it be amended at least annually and more frequently if required, information was therefore out-of-date.
- An adviser incorrectly stated that it did not have discretion to direct trades to specific broker-dealers, when in fact it did.
- Clients were provided with incorrect information about the adviser's review of their accounts, and the frequency of those reviews.

Some of the disclosure deficiencies that we find seem to come from inattention — the failure of the adviser to make sure its Form ADV reflects its current business operations. To my mind, this type of problem stems from lax controls and perhaps from an underfunded infrastructure. Other disclosure deficiencies, however, occur because the adviser either failed to identify a conflict of interest or, having spotted it, chose not to disclose it. In the former case, some advisers appear not to be giving adequate thought to what constitutes a conflict of interest. Importantly, all material conflicts of interest must be disclosed, even if the adviser has taken steps to mitigate those conflicts to ensure that it acts appropriately. And, whether intentional, inattentive or inept, the result is the same — advisory clients are not being provided with accurate information about the adviser.

Disclosure is at the heart of our securities regulatory framework, and as you would assume, it is also at the heart of our examination process. At the start of every exam, SEC examiners review the information that the adviser disseminates about its business, which includes Form ADV, parts I and II. They look at this information to see how an adviser describes its business as well as any business practices that pose potential conflicts of interest between the adviser and its clients. Throughout the exam, the examiners will continue seeking information about how an adviser's business works and what services are provided to clients. When discrepancies or omissions between the firm's written disclosures and its actual practice are identified, this will trigger heightened scrutiny by the exam staff. As a fiduciary, it is fundamental that what you tell your clients is, in fact, how you conduct your business.

How does an adviser guard against disclosure problems? As you know, the Compliance Rule requires an adviser to adopt and implement policies and procedures to prevent violations, including disclosure violations. To implement this, some firms conduct a periodic in-depth review of the adviser's ADV, along with all other written materials provided to clients and to the public — and then, they compare these disclosures against the firm's actual business operations. The review is conducted by a group of knowledgeable employees who represent all aspects of the firm — from compliance to portfolio management to trading desk to business operations. This is important, because disclosures must reflect actual practice, and who better to know the nature of the firm's actual practices than those who are actually doing it. This practice also helps keep disclosures "real," and not simply aspirational or marketing literature. Then, any required changes to disclosures are made promptly. Some firms also perform this same sort of review of client portfolios to ensure that portfolio transactions are consistent with disclosures to and instructions from the client. * * * *

Endnotes

[1] "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928) (Cardozo, B).

[2] *S.E.C. v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

[3] *Id.*

[4] See 68 FR 74714, 74716 (Dec. 24, 2003), http://www.sec.gov/rules/final/ia-2204.htm.

F. Excerpt from NAASA Investment Advisers Guide

North American Association of Securities Administrators. Available at: http://www.nasaa.org/industry___regulatory_resources/investment_advisers/456.cfm

FIDUCIARY DUTY

The anti-fraud provisions of the Investment Advisers Act of 1940 and most state laws impose a duty on investment advisers to act as fiduciaries in dealings with their clients. This means the adviser must hold the client's interest above its own in all matters. Conflicts of interest should be avoided at all costs. However, there are some conflicts that will inevitably occur, such as a person being licensed as a securities agent as well as an adviser. In these instances, the adviser must take great pains to clearly and accurately describe those conflicts and how the adviser will maintain impartiality in its recommendations to clients. The SEC has said that an adviser has a duty to:

Make reasonable investment recommendations independent of outside influences

Select broker-dealers based on their ability to provide the best execution of trades for accounts where the adviser has authority to select the broker-dealer.

Make recommendations based on a reasonable inquiry into a client's investment objectives, financial situation and other factors

Always place client interests ahead of its own.

When examiners review advisory books and records, they will be on the lookout for undisclosed or misrepresented conflicts of interest and prohibited practices. Some are obvious and some not so obvious. Some examples of practices that advisers should avoid are:

Acting as an issuer or affiliate of an issuer of securities

Recommending unregistered, non-exempt securities or the use of unlicensed broker-dealers

Any activity that acts as a fraud or deceit on clients

Charging unreasonable fees

Failing to disclose to all customers the availability of fee discounts

Using contracts which seek to limit or avoid an adviser's liability under the law (hedge clauses)

Limiting a client's options with regard to the pursuit of a civil case or arbitration

Borrowing money from or lending money to clients

Other situations which require disclosure of the conflict include, but are not limited to:

The adviser or its employees are also acting as a broker-dealer and/or securities agent

The adviser is receiving transaction-based compensation, including 12b-1 or other marketing fees, related to securities recommended to its clients

The adviser receives any type of compensation from any source for soliciting or referring clients to another adviser or a broker-dealer.

Hidden fees in the form of undisclosed service charges, wrap fees or expenses reimbursed by other parties.

The examiner will view perceived conflicts from the point of view of the customer; was the disclosure or lack of disclosure a factor in the client's decision to use an adviser's services or ratify an adviser's recommendations? Was the customer misled? Was the customer placed at a disadvantage or taken unfair advantage of as a result of the conflict and the adviser's compliance with disclosure requirements? The burden of proof lies with the adviser.

G. Duty of Loyalty—Uniform Trust Code

SECTION 802. DUTY OF LOYALTY.

(a) A trustee shall administer the trust solely in the interests of the beneficiaries.

(b) Subject to the rights of persons dealing with or assisting the trustee as provided in Section 1012, a sale, encumbrance, or other transaction involving the investment or management of trust property entered into by the trustee for the trustee's own personal account or which is otherwise affected by a conflict between the trustee's fiduciary and personal interests is voidable by a beneficiary affected by the transaction unless:

> (1) the transaction was authorized by the terms of the trust;
>
> (2) the transaction was approved by the court;
>
> (3) the beneficiary did not commence a judicial proceeding within the time allowed by Section 1005;
>
> (4) the beneficiary consented to the trustee's conduct, ratified the transaction, or released the trustee in compliance with Section 1009; or
>
> (5) the transaction involves a contract entered into or claim acquired by the trustee before the person became or contemplated becoming trustee.

(c) A sale, encumbrance, or other transaction involving the investment or management of trust property is presumed to be affected by a conflict between personal and fiduciary interests if it is entered into by the trustee with:

> (1) the trustee's spouse;
>
> (2) the trustee's descendants, siblings, parents, or their spouses;
>
> (3) an agent or attorney of the trustee; or
>
> (4) a corporation or other person or enterprise in which the trustee, or a person that owns a significant

interest in the trustee, has an interest that might affect the trustee's best judgment.

(d) A transaction between a trustee and a beneficiary that does not concern trust property but that occurs during the existence of the trust or while the trustee retains significant influence over the beneficiary and from which the trustee obtains an advantage is voidable by the beneficiary unless the trustee establishes that the transaction was fair to the beneficiary.

(e) A transaction not concerning trust property in which the trustee engages in the trustee's individual capacity involves a conflict between personal and fiduciary interests if the transaction concerns an opportunity properly belonging to the trust.

(f) An investment by a trustee in securities of an investment company or investment trust to which the trustee, or its affiliate, provides services in a capacity other than as trustee is not presumed to be affected by a conflict between personal and fiduciary interests if the investment otherwise complies with the prudent investor rule of [Article] 9. In addition to its compensation for acting as trustee, the trustee may be compensated by the investment company or investment trust for providing those services out of fees charged to the trust. If the trustee receives compensation from the investment company or investment trust for providing investment advisory or investment management services, the trustee must at least annually notify the persons entitled under Section 813 to receive a copy of the trustee's annual report of the rate and method by which that compensation was determined.

(g) In voting shares of stock or in exercising powers of control over similar interests in other forms of enterprise, the trustee shall act in the best interests of the beneficiaries. If the trust is the sole owner of a corporation or other form of enterprise, the trustee shall elect or appoint directors or other managers who will manage the corporation or enterprise in the best interests of the beneficiaries.

(h) This section does not preclude the following transactions, if fair to the beneficiaries:

(1) an agreement between a trustee and a beneficiary relating to the appointment or compensation of the trustee;

(2) payment of reasonable compensation to the trustee;

(3) a transaction between a trust and another trust, decedent's estate, or [conservatorship] of which the trustee is a fiduciary or in which a beneficiary has an interest;

(4) a deposit of trust money in a regulated financial-service institution operated by the trustee; or

(5) an advance by the trustee of money for the protection of the trust.

(i) The court may appoint a special fiduciary to make a decision with respect to any proposed transaction that might violate this section if entered into by the trustee.

H. Uniform Prudent Investor Act Standard of Care

The following is the standard of care enunciated in the Uniform Prudent Investor Act:

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

(1) general economic conditions;

(2) the possible effect of inflation or deflation;

(3) the expected tax consequences of investment decisions or strategies;

(4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;

(5) the expected total return from income and the appreciation of capital;

(6) other resources of the beneficiaries;

(7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and

(8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.[61]

[61] Uniform Prudent Investor Act § 2.